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IRS RELEASES SIGNAL CHANGES FOR COMMERCIAL MORTGAGE LOAN BORROWERS AND LENDERS

Even before the peak of the market for packaging commercial mortgage loans into Commercial Mortgage-Backed Securities (“CMBS”), industry participants recognized that the tax benefits of the Real Estate Mortgage Investment Conduits (“REMIC”) structure carried the price of restrictions on flexibility to modify loan terms to reflect changing circumstances.¹ On March 19, 2007, the Internal Revenue Service (“IRS”) and the Department of the Treasury requested input from the public on whether the REMIC regulations should be amended to permit additional types of modifications typically incurred in the servicing of commercial mortgage loans.² The process has been a slow one; some industry sources cite efforts in this area as far back as 2004. The Treasury Department did not publish any proposed regulations in response to Notice 2007-17 until November, 2007³, and a public hearing was not held to discuss those proposed regulations until April 4, 2008⁴.

When the housing market “bubble” burst so spectacularly and with such devastating consequences for the American economy, it was considered newsworthy that the requirements of the IRS applicable to REMICs prohibited amendments to the terms of home mortgage loans until the homeowner had actually defaulted on the loan. This was not a surprise to commercial real estate investors, though. Change came somewhat more rapidly in the

residential area, as the IRS’ issuance of Revenue Procedure 2008-28 in June, 2008 set out the terms under which residential loan modifications would not have adverse consequences to the REMIC structure. Now, 15 months later, the commercial real estate industry is seeing an easing of the REMIC regulations for commercial mortgage loan modifications.

On September 15, 2009, the IRS announced two changes to the REMIC rules that will allow greater flexibility in amending commercial mortgage loans: Revenue Procedure 2009-45 (“RevProc 2009-45”) sets out the conditions under which a loan with a “significant risk of default” may be amended without causing the REMIC in which the loan is held to lose its pass-through tax status (its effectiveness was made retroactive to January 1, 2008); and changes to Section 1.860G of the Treasury Regulations (the “Amended Regulations”) that permit the addition, change, release or substitution of collateral for, or the credit enhancement of, a mortgage loan held in a REMIC (effective as of September 16, 2009).⁵

RevProc 2009-45

Under existing tax law, a so-called “significant modification”⁶ to a loan held in a REMIC is permitted without adverse consequences to the REMIC only if the loan is in default or if a default is reasonably foreseeable. RevProc 2009-45 allows parties to treat a default as

¹ REMICs are treated as pass-through entities for Federal tax purposes; if the REMIC complies with the applicable regulations, including that (stated broadly) the parties to a loan could not enter into a significant modification to an underlying mortgage loan unless the loan was in default or a default was reasonably foreseeable, then the income of the REMIC is *not* subject to taxation at the REMIC level, but only as income of the owners of the REMIC securities.

² IRS Notice 2007-17.

³ See REG-127770-07 at 72 FR 63523, Nov 9, 2007.

⁴ See 73 FR 12041.

⁵ (In IRS Notice 2009-79, also issued September 15, 2009, the IRS solicited public comment as to whether the Amended Regulations should be extended to apply to securitizations structured as “grantor trusts”).

⁶ This term is defined at length in the Treasury Regulations applicable to REMICs.



"reasonably foreseeable" if the holder of the loan (or the servicer acting on its behalf) "reasonably believes that there is a significant risk of default of the pre-modification loan upon maturity of the loan or at an earlier date...based on a diligent contemporaneous determination of that risk".⁷ Thus, RevProc 2009-45 requires two key findings in considering any proposed modification to a loan in a REMIC: a "significant risk of default" if the loan is not amended, and a "diligent contemporaneous determination" of the risk.

The IRS clearly sought to give comfort to the commercial real estate industry that it would take a broad view of what was a "significant risk of default". The text of RevProc 2009-45 specifically notes that defaults that would occur more than one year in the future come within a "significant risk of default", and that there is no maximum period after which a default is automatically not foreseeable.⁸

In considering the risk of default, RevProc 2009-45 specifies that the loan holder or servicer "may take into account credible written factual representations made by the issuer [borrower] of the loan if the holder or servicer neither knows nor has reason to know that such representations are false".⁹ Given that the borrowers of most loans in CMBS transactions are required to be single-purpose entities, with no assets beyond the property encumbered to secure the loan, one can readily conclude that the IRS intended to give great leeway to loan servicers. The text of RevProc 2009-45 specifies broad categories of loan modifications that might be permitted. These include interest rate changes, principal forgiveness, extensions of maturity, and changes in principal amortization.¹⁰ Taken as a whole, then, RevProc 2009-45 removes the tax consequences that stood in the way of making significant economic changes to the terms of the loans held in the REMIC.

Amended Regulations

The Amended Regulations will permit a wide range of loan amendments that previously constituted "significant modifications", even for loans that are not in default and for which no default is reasonably foreseeable (even with the changes of RevProc 2009-45). Among these permitted changes are additions, releases and substitutions of collateral, and changes in guarantees and other credit enhancements; in all cases, though, the modified loan must continue to meet the test of being "principally secured" by real property. At the same time, though, the Amended Regulations will require that the "principally secured" test be satisfied for any release or substitution of collateral or changes in guarantees - even if permitted under prior law or under the terms of the applicable loan documents themselves.

The "principally secured" test is a longstanding feature of the REMIC regulations. Prior to the Amended Regulations, for a loan to be deemed "principally secured" by real property, the value of the property was required to have been at least 80% of the amount of the loan (*i.e.*, the loan-to-value ratio could not exceed 125%), as determined at the time of origination or securitization of the loan; no on-going application of this test was required.¹¹

Under the Amended Regulations, a modified loan will be deemed "principally secured" by real property if it meets one of two tests: either the fair market value of the real property is at least 80% of the principal amount of the loan (*i.e.*, the loan-to-value ratio does not exceed 125%), determined after giving effect to the modification of the loan, or the fair market value of the real property securing the loan after the modification must equal or exceed the value of the real property that secured the loan before the modification.

The standards a loan servicer or holder must meet to demonstrate compliance with the "principally secured" test vary. If the loan is to satisfy the 80% or greater standard, then the Amended Regulations state that the only requirement is that "the servicer reasonably believes" that it does so as of the date of the modification based on either a current appraisal, an update to the appraisal received at origination, the sales price of the underlying property (in the case of a loan assumption), or some other commercially reasonable valuation method.¹² In the case of a loan where, at the time of the modification, the loan fails to meet the 80% test, then the servicer or loan holder must obtain a current or updated appraisal, or some other commercially reasonable valuation method, and the servicer must not actually know or have reason to know that the test is not satisfied.¹³

One key change that will complicate existing loan transactions is found in the Amended Regulations. Previously, the "principally secured" test was only applied at the time of origination or securitization. Under the Amended Regulations, however, the "principally secured" test is applied to any release of collateral – even if it would not have constituted a "significant modification" under prior law (such as because it was written in to the underlying loan documents). This provision of the Amended Regulations can create a conflict between the borrower's rights under the applicable loan documents and the loan servicer's obligation under the Pooling and Servicing Agreement that the servicer not take any action that would violate the REMIC regulations; we suggest you consult with us immediately if you are a party to a transaction that presents this situation.

⁷ RevProc 2009-45 at §5.03.

⁸ RevProc 2009-45 at §5.03.

⁹ RevProc-45 at §5.03.

¹⁰ RevProc 2009-45 at §2.06.

¹¹ See Comment 2 to the Amended Regulations.

¹² Treas. Reg. 1.860G-2(b)(7)(ii).

¹³ Treas. Reg. 1.860G-2(b)(7)(iii).

Industry Impact

Taken together, the Amended Regulations and RevProc 2009-45 will give servicers greater leeway to amend mortgage loans than had previously existed. The combined impact of the Amended Regulations and RevProc 2009-45 could be significant, but at this point we foresee more questions than answers as to what these changes will mean for individual mortgage loans.

The most significant caveat arises from the potential for conflict between loan servicers and CMBS investors. How will servicers balance this new tax flexibility with their duties to the REMIC investors as set forth in the related Pooling and Servicing Agreement (“PSA”)?

Servicers must act in accordance with the “servicing standard”. Servicers must meet four tests, which (while worded differently in each PSA) can generally be summarized as follows: (1) the servicer’s actions must meet the same standards used in servicing loans for their own account or servicing for third parties (whichever is a higher standard); (2) the servicer must work for the timely collection of all mortgage loan payments as and when due; (3) the servicer must work to maximize the “net present value” of recovery on any defaulted loan; and (4) the servicer must act without regard to any relationship with the borrower, any ownership interest it has in the REMIC, any obligation it has to make advances, its right to receive fees under the PSA, or its ownership or servicing of outside assets.

The servicing standard, however, does not provide the requisite guidance as to how to utilize the newly granted leeway to modify loan terms. How does a servicer evaluate the “net present value” under a workout proposal if the future value is based on assumptions as to future leases, future operations and future market conditions? Given that the special servicer – who has the duty to oversee loan workouts under PSAs generally – is appointed by (and often affiliated with) the owner of subordinate REMIC interests, are servicers more likely to use assumptions for calculating future “net present value” that favor modifications and extensions, even if doing so causes holders of AAA-rated securities not to be paid principal on a timely basis?

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We also note that RevProc 2009-45 deals only with the existence of a “significant risk of default” in considering loan modifications; it does not address the loss severity likely to arise. Many CMBS investors are more focused on loss severity and timing of realization of principal, and less on whether the underlying loans are or are not in default. This, too, is an area ripe for conflict between parties to a PSA over a proposed modification that is likely to reduce the severity of the loss (and thus benefit subordinate holders) even though it does not reduce the likelihood of a default occurring.

It is possible that internal servicing disputes will slow the modification process for borrowers. Mortgage loans that are not in default generally remain under the auspices of the master servicer, rather than the special servicer; if the conditions for transferring a loan to “special servicing” are not satisfied, will master servicers be able to carry their share of the load of complex workout negotiations? Will master servicers and special servicers be able to speak with one voice, or will borrowers be forced to negotiate a deal with a master servicer and then have the special servicer try to take a second bite at the apple?

Given the conflicting interests of various investor classes, it is possible that the servicing industry will not utilize the full scope of the leeway given to them under RevProc 2009-45 and the Amended Regulations. Does a servicer satisfy its obligations to CMBS investors if it allows unsupported representations of SPE borrowers to be the sole rationale for a loan modification? Is the commercial real estate industry going to return to the days of “made as instructed” appraisals? Who will enforce discipline on a fractured market? Will there be consistency from servicer to servicer, from pool to pool?

Conclusion

The Amended Regulations and RevProc 2009-45 can be a basis for significant change in the way a large share of commercial real estate debt is serviced, and thus in the way a large share of commercial real estate is held. At this time, though, they pose more questions than can readily be answered.